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Income Tax

State of California

Franchise Tax Board

Legal Division

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AGENDA

- Legislative History
- Filing Status and Substantive Differences
  - Community Property
  - Capital loss deduction - $3,000/$1,500/yr.
  - Exclusion of gain on sale of principal residence $250,000/$500,000 joint return exclusion.
  - Mortgage interest - $1,000,000/$500,000 and $100,000/$50,000
  - Rental real estate passive loss - $25,000/$12,500/yr max.
- Contributions and Deductions for IRAs
- Contributions to Roth IRAs (including rollovers)
- Tax-favored Accounts
- Qualified Plans
- Classification of Business Entities
- Out-of-State Legal Unions
- Questions?

Legislative History

AB 25 (2001)

New bill that added 18 new rights for domestic partnerships, including certain limited tax benefits (Rev. & Tax. Code sec. 17021.7):

- IRC sec. 105(b) – Amounts received for health care
- IRC sec. 106(a) – Employer-provided health insurance
- IRC sec. 162(l) – Self-employed health insurance above-the-line deduction
- IRC sec. 213(a) – Itemized medical expense deduction

This allows an exclusion from gross income for employer-provided accident and health insurance and employer-provided medical expense reimbursement for an RDP and the RDP's dependents. It also allows an itemized deduction for amounts paid for the medical expenses of an RDP or the RDP's dependent.

Legislative History (cont'd)

AB 205 (2003)

- Bill made changes to various California laws regarding RDPs, including the creation of community property rights.
- Contrary to other aspects:
  - RDPs cannot file joint returns but must use the same filing status on California income tax return as used on each individual's federal income tax return.
  - Earned income is not community property for state income tax purposes.

SB 1827 (2006)

- Effective for taxable years beginning on or after January 1, 2007.
- This significant tax legislation requires RDPs to file their California income tax returns using the same rules applicable to a married person.
- Provided that federal adjusted gross income (AGI) for limitations of RDPs that file joint California return will be equal to: federal AGI (RDP 1) + federal AGI (RDP 2).

Legislative History (cont'd)

<u>SB 105 (2007)</u>

- Effective for taxable years beginning on or after January 1, 2007.
- Revises the rules of SB 1827 re: federal AGI so that federal AGI of an RDP or former RDP for limitation purposes will be the AGI determined as if the RDP or former RDP filed a federal income tax return using the same filing status as used to file their California income tax return.
  - If no RDP adjustments, simply use the AGI(s) on the federal return(s).
  - If an adjustment is necessary, use the worksheet in new FTB Pub. 737 or a *pro forma* federal return.
- "Spouse" means "RDP" except if to do so:
  - Disqualifies a deferred compensation plan
  - Creates California only "tax-favored" account
  - Results in the different classification of a business entity – S Corp or LLC

Adjusted Gross Income

- Federal Adjusted Gross Income (AGI) is used to determine various limits, including:
  - Medical expenses – greater than 7.5% of AGI
  - Miscellaneous itemized deductions – greater than 2% of AGI
  - Contributions to a Roth IRA
  - Deductions for IRA contributions
  - Phase-out of itemized deductions
- Federal Form 1040, page 1, line 37 “adjusted gross income.”

Adjusted Gross Income (cont'd)

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2007
IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20
OMB No. 1545-0074

Label (See instructions on page 12.) Use the IRS label. Otherwise, please print or type.
LABEL HERE
- Your first name and initial | Last name | Your social security number
- If a joint return, spouse's first name and initial | Last name | Spouse's social security number
- Home address (number and street). If you have a P.O. box, see page 12. | Apt. no.
- City, town or post office, state, and ZIP code. If you have a foreign address, see page 12.

▲ You must enter your SSN(s) above. ▲

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 12) ▶ ☐ You ☐ Spouse
Checking a box below will not change your tax or refund.

Filing Status
Check only one box.
1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 13.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 14)

Exemptions
6a ☐ Yourself. If someone can claim you as a dependent, do not check box 6a
b ☐ Spouse
Boxes checked on 6a and 6b

c Dependents:

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 15)
			☐
			☐
			☐
			☐

If more than four dependents, see page 15.
No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 16)

Dependents on 6c not entered above

d Total number of exemptions claimed
Add numbers on lines above ▶

Income
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.
If you did not get a W-2, see page 19.
Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7
8a	Taxable interest. Attach Schedule B if required	8a
b	Tax-exempt interest. Do not include on line 8a	8b
9a	Ordinary dividends. Attach Schedule B if required	9a
b	Qualified dividends (see page 19)	9b
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)	10
11	Alimony received	11
12	Business income or (loss). Attach Schedule C or C-EZ	12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13
14	Other gains or (losses). Attach Form 4797	14
15a	IRA distributions 15a / b Taxable amount (see page 21)	15b
16a	Pensions and annuities 16a / b Taxable amount (see page 22)	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17
18	Farm income or (loss). Attach Schedule F	18
19	Unemployment compensation	19
20a	Social security benefits 20a / b Taxable amount (see page 24)	20b
21	Other income. List type and amount (see page 24)	21
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22

Adjusted Gross Income

23	Educator expenses (see page 26)	23
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24
25	Health savings account deduction. Attach Form 8889	25
26	Moving expenses. Attach Form 3903	26
27	One-half of self-employment tax. Attach Schedule SE	27
28	Self-employed SEP, SIMPLE, and qualified plans	28
29	Self-employed health insurance deduction (see page 26)	29
30	Penalty on early withdrawal of savings	30
31a	Alimony paid b Recipient's SSN ▶	31a
32	IRA deduction (see page 27)	32
33	Student loan interest deduction (see page 30)	33
34	Tuition and fees deduction. Attach Form 8917	34
35	Domestic production activities deduction. Attach Form 8903	35
36	Add lines 23 through 31a and 32 through 35	36
37	Subtract line 36 from line 22. This is your adjusted gross income ▶	37

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 83. Cat. No. 11320B Form **1040** (2007)

Filing Status and Substantive Differences

Generally the IRC treats a married couple as a single economic unit. As a result:

- Where the IRC prescribes a specific dollar limit on a deduction, exclusion, or other rule, that dollar limit for a single taxpayer is usually the same as the dollar limit for two married persons who file a joint return.
- When a married person files a separate return, the dollar limit is one-half the amount for a single person or a married couple that files a joint return.
- In many cases, the treatment of a married couple is less favorable than the treatment provided to two single taxpayers.

Filing Status and Substantive Differences

Treating an RDP as a married person for California tax purposes has the effect of changing the dollar amount of various limits on exclusions, deductions, etc. for California purposes.

Until federal law treats RDPs as spouses and allows them to file joint federal income tax returns, there will be substantive differences between federal and California income tax law.

Filing Status and Substantive Differences

Examples:

- Community Property
- IRC sec. 1211(b) Capital loss deduction - $3,000/$1,500/yr.
- IRC sec. 121 Exclusion of gain on sale of principal residence $250,000/$500,000 joint return exclusion.
- IRC sec. 163(h) Mortgage interest - $1,000,000/$500,000 and $100,000/$50,000
- IRC sec. 469 Rental real estate passive loss - $25,000/$12,500/yr max.

Community Property

Community Property vs. Separate Property – Capital gain/loss issues

- In general, community property is not an issue for spouses/RDPs that file a joint return. However, if RDPs file as married/RDP filing separate, there could be an issue.

- The capital loss from separately owned asset of one RDP can only offset gains from that RDP's other separately assets or community property (assets owned by both RDPs).

Capital Gains/Losses

Examples:

- Chris reported a $3,000 capital loss and Pat reported a $2,000 capital loss on their separate federal returns. Capital losses are limited to $3,000. When they recalculate their federal return, as if married, they will make a $2,000 filing status adjustment on the worksheet or on their *pro forma* federal return. (A $3,000 loss plus a $2,000 loss equals a $5,000 loss; since they are limited to a $3,000 loss, the adjustment will be for $2,000.

- If Chris and Pat are filing separately using the married/RDP filing separately filing status, they are each limited to a $1,500 loss. Therefore, Chris will make a $1,500 filing status adjustment and Pat will make a $500 filing status adjustment on their separately filed returns.

- Any losses in excess of gain that were deductible on a federal return but not deductible for California purposes may be carried forward for California purposes in accordance with applicable rules.

Exclusion of Gain on Sale of Principal Residence

Examples:

An RDP filing as married/RDP filing jointly is able to exclude up to $500,000.

- If you sold your principal residence, had gain in excess of $250,000, excluded only $250,000 of gain on your federal return, and are using the MFJ filing status, enter the difference between your total gain (up to $500,000) and the $250,000 you excluded from your federal income on the worksheet or enter up to $500,000 on the *pro forma* federal return.

- This exclusion would apply if, in addition to the other requirements of IRC section 121, only one of the RDPs owns the home, as long as, both RDPs used the home as their principal residence for at least 2 of the 5 years before the sale.

Mortgage Interest

- The aggregate amount of debt that can be treated as acquisition indebtedness for any period cannot exceed $1,000,000 ($500,000 for MFS).
- Home equity indebtedness (any debt other than acquisition indebtedness) the aggregate amount cannot exceed $100,000 ($50,000 for MFS).

- Example: Pat owns a home with acquisition indebtedness of $700,000 and Chris owns a home with acquisition indebtedness of $900,000. Each deducted the full amount of mortgage interest paid by each on their single federal returns. The mortgage interest deductible on their California returns will be limited as follows:
  - If they file MFJ, the total amount of interest deductible is limited to interest attributable to $1,000,000 of acquisition indebtedness.
  - If each files MFS, the total amount of interest that each may deduct is limited to interest on acquisition indebtedness of $500,000.
  - The same rules apply to home equity indebtedness.

Passive Losses/Rental Real Estate

- The $25,000 allowance ($12,500 for married/RDP filing separate) is reduced (but not below zero) by 50% of the amount by which the taxpayer's AGI as specially computed exceeds $100,000 ($50,000 for married/RDP filing separate).

- Example: Chris has an AGI of $90,000 and reported a $25,000 passive loss (owns and manages a rental property) on her federal return and Pat has an AGI of $50,000 and had no passive loss on her single federal return. Rental real estate losses are limited to $25,000 with a phase out when the taxpayer's AGI exceeds $100,000. Because they must recalculate their federal AGI, as if married, they will have a combined AGI of $140,000 and will be required to reduce the rental real estate loss on their California return to $5,000. They must make a $20,000 filing status adjustment on the worksheet or on their *pro forma* federal return.

Contributions and Deductions for IRAs

An RDP will be treated as a spouse for California purposes but will not be treated as a spouse for federal purposes.

In general, IRC Sec. 219 allows a taxpayer to make a contribution to an IRA in an amount equal to the lesser of a fixed amount or the individual's compensation for the taxable year. For 2007, the maximum deduction is $4,000 ($5,000 for those 50 or older).

For taxpayer's filing MFJ, IRC sec. 219(c) allows the compensation of a spouse to provide the basis for an increased contribution to an IRA when the taxpayer's compensation includible in gross income is less than the includible compensation of his or her spouse.

Contributions and Deductions for IRAs

The compensation of one RDP could provide the basis for an increased contribution to an IRA for California purposes. However, that increased contribution would be considered an excess contribution for federal purposes and subject to an additional federal tax of 6%.

Does SB 105 prevent a contribution to an IRA based on the compensation of a partner? No. But the contribution would be subject to the 6% federal tax.

Similarly, if federal law would deny or limit a deduction for a contribution to an IRA if the spouse of a taxpayer is an “active participant” in an employer-provided retirement plan, an RDP may be denied a deduction for California purposes for a contribution to an IRA if the RDP’s partner is an active participant in an employer-provided retirement plan. In this circumstance the RDP would get what’s known as “basis” in the IRA for California purposes to prevent taxation when nondeductible amounts in the IRA are distributed.

AGI Limits – Taxpayer is an Active Participant – IRA Deduction

Filing Status	Modified AGI	Deduction
• Single or HOH	$52,000 or less	a full deduction.
	more than $52,000 but less than $62,000	a partial deduction.
	$62,000 or more	no deduction.
• Married/RDP filing jointly or qualifying widow(er)	$83,000 or less	a full deduction.
	more than $83,000 but less than $103,000	a partial deduction.
	$103,000 or more	no deduction.
• Married/RDP filing separately	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

AGI Limits – Taxpayer is Not an Active Participant – IRA Deduction

Filing Status	Modified AGI	Deduction
• **Single, HOH, or qualifying widow(er)**	any amount	a full deduction.
• **Married/RDP filing jointly or separately** w/spouse/RDP **not covered** by plan	any amount	a full deduction.
• **Married/RDP filing jointly** w/spouse/RDP **covered** by plan	$156,000 or less	a full deduction.
	more than $156,000 but less than $166,000	a partial deduction.
	$166,000 or more	no deduction.
• **Married/RDP filing separately** w/spouse/RDP **covered** by plan	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

Contributions and Deductions for IRAs

Examples:

- Chris, not an active participant, makes a $4,000 contribution to an IRA. Pat, Chris' RDP, is an active participant in an employer-provided retirement plan. Because Chris's RDP is an active participant in an employer-provided retirement plan, Chris' deduction for his contribution may be limited.

- Chris has a modified AGI of $90,000 and Pat has a modified AGI of $80,000. For 2007 the federal modified AGI limitation and phase out amounts for taxpayers using the married/RDP filing joint filing status is $156,000 - $166,000 ($0 - $10,000 for married/RDP filing separate). Because Chris and Pat's combined modified AGI is $170,000, for California purposes Chris would not be allowed any deduction. They must make a $4,000 filing status adjustment on the worksheet or on their *pro forma* federal return. In addition, Chris would have a $4,000 basis for this nondeductible contribution to the IRA for California purposes.

NOTE: The federal indexed AGI amounts for IRAs for 2007 are not applicable for California purposes, but this difference is addressed in the instruction for the Schedule CA.

Contributions to Roth IRAs

IRC sec. 408A allows a contribution to a Roth IRA if a taxpayer's modified AGI is below a certain amount. The contribution amount is phased out over a range of $10,000 for modified AGI in excess of those amounts. For 2007 taxable year the dollar amounts and ranges are :

- $99,000 to $109,000 - Single
- $156,000 to $166,000 – Married filing jointly
- Zero to $10,000 – Married filing separately

Federal law imposes an additional tax on excess contributions to a Roth IRA. California does not impose an additional tax on any excess contributions. Qualified distributions from a Roth IRA (I.e., after 59½, after death, attributable to a disability, or special purpose distribution) are tax free. Previously FTB 737 indicated earnings attributable to excess contributions were taxable.

NOTE: The federal indexed AGI amounts for Roth IRAs for 2007 are applicable for California purposes

Contributions to Roth IRAs

- If an RDP makes a contribution to a Roth IRA that is permissible for federal purposes but, because of different AGIs, would be an excess contribution for California purposes:
  - The contribution would not be subject to any additional California tax.
  - Qualified distributions from a Roth IRA (i.e., after 59½, after death, attributable to a disability, or special purpose distribution) are tax free. This includes earnings attributable to excess contributions that are distributed after the due date for the year for which the excess contribution was made.

NOTE: Previously FTB 737 indicated earnings attributable to excess contributions were taxable when distributed.

Contributions to Roth IRAs

Example:

- Chris and Pat are RDPs. Chris made a contribution to his Roth IRA of $4,000. Chris' federal modified AGI is $90,000. Pat made a contribution to his Roth IRA of $4,000. Pat's federal modified AGI is $95,000. Chris and Pat's combined federal modified AGI for California purposes exceeds the $166,000 limitation for an allowable Roth IRA contribution.

- Because their combined federal modified AGI exceeds the limitation, for California purposes the Roth IRA contributions of Chris and Pat are treated as "excess contributions." However, California does not impose the 6 percent excise tax that is imposed under federal law on excess contributions to Roth IRAs.

Contributions to Roth IRAs – Rollovers/Conversions

- You can convert amounts from a traditional IRA into a Roth IRA if, for the tax year you make the withdrawal from the traditional IRA, both of the following requirements are met:
  - Your modified AGI for Roth IRA purposes is not more than $100,000.
  - You are not a married individual/RDP filing a separate return.

Contributions to Roth IRAs - Rollovers

Chris made a rollover contribution from his traditional IRA to his Roth IRA of $50,000. Chris' federal modified AGI is $90,000. Pat's federal modified AGI is $95,000. Chris' and Pat's combined federal modified AGI exceeds the $100,000 limitation for an allowable rollover Roth IRA contribution.

Because their combined federal AGI exceeds the limitation, for California purposes the rollover contribution is treated as an "excess contribution" to Chris' Roth IRA. Unlike the IRS, California does not impose an excise tax on excess contributions to Roth IRAs.

However, since the rollover distribution from Chris' traditional IRA is not a qualified rollover contribution, it will be considered a nonqualified distribution from Chris' traditional IRA and subject to California's 2.5% penalty on early withdrawals unless some other exception applies.

Tax-Favored Accounts

- The IRC authorizes several tax-favored special purpose accounts – Archer Medical Savings Accounts (MSAs), health savings accounts (HSAs), and Coverdell education savings accounts.

- Income earned on amounts in these accounts is exempt from tax. Contributions to some accounts are deductible. Rules may differ for married taxpayers.

- Distributions from these accounts for qualified expenses are often tax exempt. Qualified expenses often include expenses for family members.

- Transfers of accounts due to divorce are exempt from tax and often retain their status as a tax-favored account. A change in account beneficiary amongst family members may be nontaxable. Nonqualified distributions are includible in gross income and often subject to an additional tax.

- California provides comparable if not identical treatment for all but HSAs.

Tax-Favored Accounts

- Contributions, deductions, and distributions

California will apply the federal rules applicable to a spouse to determine the tax treatment of a contribution, the availability of a deduction, and the tax treatment of a distribution of an RDP.

Example:

If you take an early distribution from your IRA to pay the higher education expenses of the your RDP or the child of your RDP, for federal purposes you would be subject to an additional tax of 10 percent for the early withdrawal, but for California purposes you would not owe the additional tax of 2.5 percent. However, for both federal and California tax purposes, you would need to include in your taxable income the early distribution from your IRA, unless you have a basis in the IRA that may be recovered tax-free.

Tax-Favored Accounts

- EXCEPTION (SB 105): An RDP will not be treated as a spouse if to do so would result in a California-only tax-favored account (because IRS treats the transfer or change in beneficiary as a transfer to some one other than a spouse of member of the family – a nonqualified distribution) such as:
  - Transfer of portion or all of the account to an RDP incident to dissolution
  - Change beneficiary for an account to RDP or dependent of RDP

Example:

If the beneficiary of a Coverdell Education Savings Account (ESA) is changed, it is not considered a distribution if the new beneficiary is “a member of the family” of the old beneficiary. Because federal law does not recognize an RDP as a spouse, any change in beneficiary to a beneficiary’s RDP or the child of the RDP would result in the Coverdell ESA no longer being treated as a qualified tax-favored account for federal income tax purposes. Instead, the change in beneficiary would be considered a non-qualified distribution from the tax-favored account. Under SB 105, an RDP will not be treated as a spouse for purposes of changing the beneficiary of a Coverdell ESA.

Qualified Plans

- In general, contributions to a qualified deferred compensation plan are deductible by the contributor but not currently taxable to the employee.
- IRC and the Employee Retirement Income Security Act (ERISA) establish qualification requirements for a broad category of private sector deferred compensation plans.
- California conforms to the IRC on this provision. In addition, ERISA preempts any state law relating to an employee benefit plan governed by ERISA.

Issue

- Anti-alienation requirement prohibits assignment or transfer of plan assets except for qualified domestic relations orders (QDROs), and certain survivor annuities. Federal law known as the Defense of Marriage Act (DOMA) prevents an RDP from being treated as a "spouse" for federal purposes.

Resolved

- SB 105 – RDPs will not be treated as a spouse if a deferred compensation plan would be disqualified for federal purposes.

Classification of Business Entities

Federal law limits the number of shareholders of an S corporation to 100 but allows a husband and wife to be treated as a single shareholder of an S corporation. Federal law also permits certain business entities (e.g. a limited liability company (LLC)) with a single owner to be disregarded as a separate entity and allows a husband and wife to be considered a single owner of a business entity.

California law provides that a federal S corporation must be an S corporation for California purposes and the classification of other entities to be the same as the federal classification.

SB 105 provides that an RDP will not be treated as a spouse if to do so would result in a different classification. As a result, two RDPs will not be treated as a single shareholder of an S corporation or a single owner of an LLC.

Out-of-State Legal Unions

- Family Code §297 provides the definition of domestic partners (i.e., domestic partnership established in California when both persons meet all the statutory requirements <u>and</u> register with the California Secretary of State).

- In 2003, Family Code §299.2 was added to provide that a same sex legal union (other than a marriage) validly formed in another jurisdiction, and *substantially similar* to a California RDP, is considered a valid domestic partnership in California.

<u>Resolution Pending</u>

FTB requested an Attorney General opinion and expects an answer soon.

Questions?